ACLI
Financial Security. For Life.

John Bruins
Senior Actuary
202.624.2169 t
202.572.4721 f
johnbruins@acli.com

July 29, 2008

Mr. Sheldon Summers, Chair
Reinsurance Subgroup of the Life and Health Actuarial Task Force
California Department of Insurance
Ronald Reagan State Office Building
South tower, 300 South Spring Street
Los Angeles, CA 90013

Re: **Comments on VM-20 (3/29/08 Exposure) Amendment proposal VM-20_080329_025**

Dear Sheldon,

The American Council of Life Insurers (ACLI) is pleased to submit the following comments on behalf of our member companies regarding the proposed amendment VM20_080329_025 to the VM20 Section of the Valuation Manual exposed on March 29, 2008. The ACLI represents three hundred fifty-three (353) member companies operating in the United States, of which three hundred forty-five (345) are legal reserve life insurance companies, and eight (8) are fraternal benefit societies. These 353 member companies account for 93 percent of total assets, 93 percent of the life insurance premiums, and 94 percent of annuity considerations in the United States.

Importance of Gross Reserves

ACLI agrees that it is important to present separately gross reserves and reinsurance credits in statutory financial statements. For reinsurance ceded to unauthorized reinsurers, the amount of reinsurance reserve credit determines collateral requirements under the Credit for Reinsurance Model Regulation. For all ceded reinsurance, disclosure of reinsurance counterparty exposure increases transparency regarding the ceding company's risk profile.

The currently exposed draft of VM-20 calculates reserves on fully modeled cash flows **net** of reinsurance. A separate gross reserve is then calculated, and the reinsurance credit is the difference between the two. Amendment Proposal VM20_080329_025 changes the basic approach to start with a model of **gross** cash flows, and then calculates a separate reinsurance credit based on just the reinsurance cash flows. We support the current approach.

This Proposal is Unworkable

Unfortunately, VM20_090329_025 has serious flaws, and we must oppose its adoption. The following are the most significant issues we have identified so far in the proposed amendment.

First, the amendment does not properly handle the cash value floor. The simplest example is a cash value policy, where the policy is 100% coinsured. We should expect the ceding company to calculate a net deterministic reserve of zero. Under the amendment proposal, the ceding company's gross deterministic reserve will be at least equal to the cash value floor, and the

© 2008 National Association of Insurance Commissioners

reserve credit will be the present value of reinsurance cash flows (RD + RA). If the present value of reinsurance cash flows is less than the CV for one or more policies in the block, the ceding company's net reserve will be greater than zero - possibly much greater. Furthermore, the reinsurer would still be subject to the cash value floor. Therefore, if the cash value is greater than the seriatim reserve, the assuming company would hold a reserve equal to the cash surrender value, even though the ceding company is unable to take full credit for it.

Second, the proposal makes it impossible to use an appropriate path of discount rates for taking present values. The amendment proposal sets the reserve credit as the present value of reinsurance cash flows (RD and RA) discounted "using the path of discount rates for the corresponding model segment." The proposal does not specify if the discount rates are to be determined using gross or net cash flows. The path of rates calculated using gross cash flows will generally differ from the path determined by using net cash flows. In most cases neither version of the discount rates when applied only to RD and RA would exactly reproduce the difference between a full gross-basis seriatim reserve and a full net-basis seriatim reserve, because different interest rate paths would apply to different cash flow components.

Third, the amendment focuses on the deterministic reserve calculation and leaves open several questions with regard to the stochastic reserve and minimum reserve calculations. The amendment:

- Is not clear on whether the stochastic reserve should also be calculated gross.
- Defines the credit for reinsurance solely in terms of deterministic reserve cash flow elements. Such a credit is likely to be mismatched to a gross stochastic reserve.
- Does not specify whether the "greater of" comparison between stochastic and deterministic reserve should be done a) gross to gross, b) net to net, or c) both ways, with the reserve credit being the difference between the "greater of, gross basis" and "greater of, net basis." (Note that the current language in VM-20 D.2.3, stricken by this amendment, takes approach (c) precisely to handle the complications from cash value floors and varying paths of discount rates.)

These examples illustrate the difficulty in completely recasting the existing language of VM-20 into gross-basis formulas and separate, explicit formulas for reserve credit in order to arrive at a net result. We caution that there may be other difficulties requiring time consuming review. For example, the Academy Reinsurance Work Group labored to devise language and formulas on the net-cash-flow basis for a per policy, cash-value-floored deterministic reserve in the presence of a variety of flexible reinsurance designs, including designs with aggregate features. If VM-20 is changed to a formulation involving gross reserve and separate reserve credit, the Work Group should be asked to reopen this topic.

Change May Not Be Necessary

ACLI respectfully asks LHATF to consider whether this considerable reworking is necessary. If a key motivation of the new amendment is to ensure that the reinsurance reserve credit and a gross reserve are calculated with appropriate assumptions and professional diligence, then ACLI believes that that objective can best be achieved through focused improvements within Section D, Reinsurance, supplemented by appropriate actuarial standards of practice, without such major changes to the whole of VM-20.

In crafting any improvements, we foresee one critical question for industry and regulators: how to achieve the objectives of measuring reserve credit without demanding more precision than the gross reserve calculation can realistically produce. The issue arises because a focus on the calculation of a gross reserve instead of a net reserve requires the ceding company to do detailed modeling of assets that it may not control, may have little or no ability to monitor or project, and would not in general need to model except in the case of recapture or insurer failure. For example, in the common case of coinsurance, the reinsurer receives and invests all the assets backing the reinsured business. The ceding company does not manage the reinsurer's assets and has limited knowledge of the reinsurer's strategies. How robustly should a ceding company be asked to project total gross asset cash flows (the reinsurer's in addition to its own) including starting portfolio, allocation of cash to reinvestment asset classes, disinvestment by asset class, total invested asset balances by class, net investment income, and related items (IMR, hedging activity, etc.)?

Furthermore, modeling the reinsurer's actions using just the ceding company's liability cash flows is artificial and not the economic reality. The ceding company could not model the reinsurer's true actions and costs realistically without also modeling the cash flows attributable to all the other clients in the reinsurer's affected business segment, an impossible task for the ceding company. At its core, Principles Based Reserves will require life insurers to attest that reserves are based on cash flows that are an accurate representation of future experience taking into account actions the insurer would take in the future. Applying the same rigor to gross reserves will effectively require many life insurers also to attest to hypothetical actions their reinsurers may or may not take in the future.

Consequently, taking the modeling of the gross reserve to extremes could impose substantial new cost and modeling complexity on ceding companies (small companies and large) and yet still produce results with a wide confidence band and debatable meaning. To avoid this, ACLI believes that VM 20 and its supporting standards should clarify the purposes for the net and gross reserve calculation and try to allow some room for cost effective solutions. Reasonable approximations and simplifications in determining the gross reserve should be allowed because they do not jeopardize the essential regulatory objectives of measuring net liabilities. ACLI is ready to assist in addressing this concern.

We ask that you reject Amendment Proposal VM-20_080329_025. We thank you for the opportunity to comment.

cc John Engelhardt

w:\sep08\tf\lha\brui0729.doc